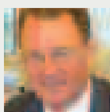
Ask the experts:

How do you keep control?

The debate on the pros and cons of change of control clauses shows no sign of dying down.



Chris Bowmer,
Group Treasurer,
Rexam

Bond investors receive little more than a promise of payment of interest and principal in due course, with no prospect of any upside if they hold to maturity, so it is not surprising if they attach importance to the quality of that promise and differentiate, by means of pricing, between the quality of these promises. The risk of an event such as a leveraged change of control, taking the bond below investment grade and forcing its unexpected and costly sale, is a BBB bond investor's worst nightmare. Arguably, the same risk applies to more highly rated bonds, as excessive leverage can be added to any situation by an acquiring third party.

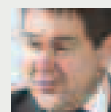
It is hardly surprising that, in the wake of a series of leveraged acquisitions of investment-grade bond issuers, more attention has been given to change of control clauses. These typically require both a change of control and a consequent downgrade to below investment grade. From the issuers' perspective, there has to be a sound reason for adding a clause which might be seen as a 'poison pill', although the mere request for protection from a would-be bondholder is certainly one to start with. It is clear that the market will charge a pricing penalty, for some issuers at least, if there is no change of control language. Shareholders, who might well benefit from a change of control and get an immediate exit from the extra risk posed by leverage, need to be sure that protection given to bondholders against their downside risk and possible lack of an exit, does not restrict their options either.

So the treasurer has to structure any change of control clause to balance these issues. Investors need to be able to get their money back if they choose not to take the interest and repayment promise of the newly leveraged issuer, while shareholders need to be sure that bond investor protection does not restrict their ability to profit from a leveraged bid.

To ensure this, there is an investor put, but at par, so there is no penalty to restrict a change of control. There is also a delay period before the put can be exercised, so it has to be clear that the event has happened and the leverage is real. The leveraged acquirer has to take account of this when structuring its acquisition debt, as funding will be needed to repay the bonds before their default triggers cross-default to the new debt. Without such a delay, the change of control put would act against legitimate shareholder interests, as it could prevent a change of control.

Another issue is the 'pre-emptive' downgrade. It is a requirement for the clause that change of control is followed by a downgrade. If a downgrade precedes a change of control, causality is lost and cannot be distinguished from an event which may not merit such protection – for example, poor business performance leading to a downgrade and then a change of control. If a credit rating agency announces an actual downgrade (below investment grade) before the change of control takes place, it risks removing the investor protection that a change of control clause is meant to provide. The correct response needs to be a credit watch/outlook change, which makes clear what the consequences of any actual change of control will be.

When Rexam issued its latest bonds, in March this year, its credit ratings were BBB/Baa3 and change of control was a hot topic after the BAA issue. It was clear that management's intention to maintain investment grade and the risk of change of control followed by downgrade were likely to be investor concerns. The company decided to deal with them upfront, and included the appropriate clauses in the bonds when the offer documents were published and the deal launched. The result was a better-structured discussion with investors on the roadshow, as change of control issues did not distract investors from assessing the nature of the Rexam credit and the terms of the offer. The phenomenal success of the exchange offer (77%) and degree of oversubscription for the additional bonds offered led us to upsize the transaction from a potentially small issue of only €350m to a benchmark size of €600m.



Malcolm Cooper,
Group Treasurer,
National Grid

On 8 March 2006 National Grid priced a €750m 4.125% bond due 2013, which was issued and settled on 21 March. The proceeds were swapped into US dollars and will be used for some of our funding requirements over the next couple of years, including a substantial capex programme; over £2bn of debt maturities; and nearly $8bn for recently announced acquisitions. The bond does not include change of control provisions.

On 27 February National Grid announced the debt-financed acquisition of KeySpan for $7.3bn and held a debt investors conference call, explaining our funding needs. Exactly a week later we announced the bond, and on 7 March we held an investor call for the bond. I expected questions on whether the bond would include change of control language and was not disappointed. I explained that the bond would not include change of control language for a number of reasons:

- None of our existing debt includes change of control language, so including it in an issue would effectively subordinate existing debt investors.
- A change of control clause would provide an additional material restriction in the way we organise ourselves. We have in the past undertaken corporate activities – such as the separation of UK regulated activities from unregulated activities and the acquisition of US assets – that could well have triggered this type of provision.
- Debt investors already benefit from significant protections provided by the regulated nature of our group. Many of our companies are required by regulators to maintain an investment-grade credit rating and a change of control would result in the need for multiple approvals in the US.

While some lenders have expressed interest in a change of control, it is by no means clear that they are willing to sacrifice any yield in exchange for this. This makes it difficult for us to conclude that there is any value in, or long-term desire for, the clause.